

# APPENDIX I

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## AS 1 : Disclosure of Accounting Policies\*

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in **bold italic** type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities'.]*

### Introduction

1. This Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.
2. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.
3. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.
4. The Institute of Chartered Accountants of India has, in Standards issued by it, recommended the disclosure of certain accounting policies, e.g., translation policies in respect of foreign currency items.
5. In recent years, a few enterprises in India have adopted the practice of including in their annual reports to shareholders a separate statement of accounting policies followed in preparing and presenting the financial statements.
6. In general, however, accounting policies are not at present regularly and fully disclosed in all financial statements. Many enterprises include in the Notes on the Accounts, descriptions of some of the significant accounting policies. But the nature and degree of disclosure vary considerably between the corporate and the non-corporate sectors and between units in the same sector.
7. Even among the few enterprises that presently include in their annual reports a separate statement of accounting policies, considerable variation exists. The statement of accounting policies forms part of accounts in some cases while in others it is given as supplementary information.
8. The purpose of this Standard is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

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\* Issued in November, 1979

<sup>1</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

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### Explanation

#### Fundamental Accounting Assumptions

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

10. The following have been generally accepted as fundamental accounting assumptions:—

a. *Going Concern*

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

b. *Consistency*

It is assumed that accounting policies are consistent from one period to another.

c. *Accrual*

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this standard.)

#### Nature of Accounting Policies

11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

13. The various standards of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises.

#### Areas in which Differing Accounting Policies are Encountered

14. The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

- (a) Methods of depreciation, depletion and amortisation
- (b) Treatment of expenditure during construction
- (c) Conversion or translation of foreign currency items
- (d) Valuation of inventories
- (e) Treatment of goodwill

- (f) Valuation of investments
- (g) Treatment of retirement benefits
- (h) Recognition of profit on long-term contracts
- (i) Valuation of fixed assets
- (j) Treatment of contingent liabilities.

15. The above list of examples is not intended to be exhaustive.

### **Considerations in the Selection of Accounting Policies**

16. The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.

17. For this purpose, the major considerations governing the selection and application of accounting policies are:—

a. *Prudence*

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

b. *Substance over Form*

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form

c. *Materiality*

Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

### **Disclosure of Accounting Policies**

18. To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

19. Such disclosure should form part of the financial statements.

20. It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

21. Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in paragraph 14. This list of examples is not, however, intended to be exhaustive.

22. Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

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23. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

### Main Principles

24. *All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.*

25. *The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.*

26. *Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.*

27. *If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.*

## AS 2 : Valuation of Inventories\*

[This Accounting Standard includes paragraphs set in ***bold italic*** type and plain type, which have equal authority. Paragraphs in ***bold italic*** type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities'.]

### Objective

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This Standard deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

### Scope

1. *This Standard should be applied in accounting for inventories other than:*

- (a) *work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Construction Contracts);*
- (b) *work in progress arising in the ordinary course of business of service providers;*
- (c) *shares, debentures and other financial instruments held as stock-in-trade; and*
- (d) *producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.*

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\*.Revised in 1999.

<sup>1</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard.

### Definitions

3. *The following terms are used in this Standard with the meanings specified:*

3.1. *Inventories are assets:*

- (a) *held for sale in the ordinary course of business;*
- (b) *in the process of production for such sale; or*
- (c) *in the form of materials or supplies to be consumed in the production process or in the rendering of services.*

3.2. *Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.*

4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

### Measurement of Inventories

5. *Inventories should be valued at the lower of cost and net realisable value.*

### Cost of Inventories

6. *The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.*

#### Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

#### Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

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9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

### Other Costs

11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

12. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

### Exclusions from the Cost of Inventories

13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- (a) abnormal amounts of wasted materials, labour, or other production costs;
- (b) storage costs, unless those costs are necessary in the production process prior to a further production stage;
- (c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- (d) selling and distribution costs.

### Cost Formulas

14. *The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.*

15. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs is inappropriate since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

**16. The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.**

17. A variety of cost formulas is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost of an item of inventory needs to be selected with a view to providing the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

### **Techniques for the Measurement of Cost**

18. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

19. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

### **Net Realisable Value**

20. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs necessary to make the sale have increased. The practice of writing down inventories below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.

21. Inventories are usually written down to net realisable value on an item- by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a

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classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

23. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date<sup>2</sup>.

24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

25. An assessment is made of net realisable value as at each balance sheet date.

### Disclosure

26. ***The financial statements should disclose:***

- (a) *the accounting policies adopted in measuring inventories, including the cost formula used; and*
- (b) *the total carrying amount of inventories and its classification appropriate to the enterprise.*

27. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

## AS 3 : Cash Flow Statements\*

### Cash Flow Statements

*[This Accounting Standard includes paragraphs set in ***bold italic*** type and plain type, which have equal authority. Paragraphs in ***bold italic*** type indicate the main principles. This Accounting Standard should*

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<sup>2</sup>Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

\*Revised in 1997

*be read in the context of its objective, the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities'.]*

This Accounting Standard is not mandatory for Small and Medium Sized Companies and non-corporate entities falling in Level II and Level III as defined in 'Applicability of Accounting Standards to Various Entities.' Such entities are however encouraged to comply with this standard.

### **Objective**

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

### **Scope**

- 1. An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.***
- Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

### **Benefits of Cash Flow Information**

3. A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.
4. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

### **Definitions**

- 5. The following terms are used in this Standard with the meanings specified:***

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<sup>1</sup>Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

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- 5.1. **Cash** comprises cash on hand and demand deposits with banks
- 5.2 **Cash equivalents** are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
- 5.3. **Cash flows** are inflows and outflows of cash and cash equivalents.
- 5.4. **Operating activities** are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
- 5.5. **Investing activities** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- 5.6. **Financing activities** are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

### **Cash and Cash Equivalents**

6. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

7. Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

### **Presentation of a Cash Flow Statement**

8. The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.
9. An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.
10. A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

### **Operating Activities**

11. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

12. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

- (a) cash receipts from the sale of goods and the rendering of services;
- (b) cash receipts from royalties, fees, commissions and other revenue;
- (c) cash payments to suppliers for goods and services;
- (d) cash payments to and on behalf of employees;
- (e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- (f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
- (g) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

13. Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

14. An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

### **Investing Activities**

15. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

- (a) cash payments to acquire fixed assets (including intangibles).  
These payments include those relating to capitalised research and development costs and self-constructed fixed assets;
- (b) cash receipts from disposal of fixed assets (including intangibles);
- (c) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- (d) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- (e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
- (f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

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- (g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- (h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

16. When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

### Financing Activities

17. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:

- (a) cash proceeds from issuing shares or other similar instruments;
- (b) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
- (c) cash repayments of amounts borrowed.

### Reporting Cash Flows from Operating Activities

18. *An enterprise should report cash flows from operating activities using either:*

- (a) *the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or*
- (b) *the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.*

19. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

- (a) from the accounting records of the enterprise; or
- (b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:
  - i) changes during the period in inventories and operating receivables and payables;
  - ii) other non-cash items; and
  - iii) other items for which the cash effects are investing or financing cash flows.

20. Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and

- (c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

### Reporting Cash Flows from Investing and Financing Activities

21. *An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 22 and 24 are reported on a net basis.*

### Reporting Cash Flows on a Net Basis

22. *Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:*

- (a) *cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and*
- (b) *cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.*

23. Examples of cash receipts and payments referred to in paragraph 22(a) are:

- (a) the acceptance and repayment of demand deposits by a bank;
- (b) funds held for customers by an investment enterprise; and
- (c) rents collected on behalf of, and paid over to, the owners of properties.

Examples of cash receipts and payments referred to in paragraph 22(b) are advances made for, and the repayments of:

- (a) principal amounts relating to credit card customers;
- (b) the purchase and sale of investments; and
- (c) other short-term borrowings, for example, those which have a maturity period of three months or less.

24. *Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:*

- (a) *cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;*
- (b) *the placement of deposits with and withdrawal of deposits from other financial enterprises; and*
- (c) *cash advances and loans made to customers and the repayment of those advances and loans.*

### Foreign Currency Cash Flows

25. *Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on*

## I.14 Accounting

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***cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.***

26. Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

27. Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

### Extraordinary Items

***28. The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.***

29. The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

### Interest and Dividends

***30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.***

31. The total amount of interest paid during the period is disclosed in the cash flow statement whether it has been recognised as an expense in the statement of profit and loss or capitalised in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

32. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

33. Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

### Taxes on Income

34. *Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.*

35. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

### Investments in Subsidiaries, Associates and Joint Ventures

36. *When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.*

### Acquisitions and Disposals of Subsidiaries and Other Business Units

37. *The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.*

38. *An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:*

- (a) *the total purchase or disposal consideration; and*
- (b) *the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.*

39. The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

### Non-cash Transactions

40. *Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.*

41. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are:

- (a) the acquisition of assets by assuming directly related liabilities;
- (b) the acquisition of an enterprise by means of issue of shares; and
- (c) the conversion of debt to equity.

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### Components of Cash and Cash Equivalents

42. *An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.*

43. In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

44. The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

### Other Disclosures

45. *An enterprise should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.*

46. There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it. Examples include cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise.

47. Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include:

- (a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- (b) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

48. The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

### Illustration I

#### Cash Flow Statement for an Enterprise other than a Financial Enterprise

*This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.*

1. The illustration shows only current period amounts.
2. Information from the statement of profit and loss and balance sheet is provided to show how the statements of cash flows under the direct method and the indirect method have been derived. Neither the statement of profit and loss nor the balance sheet is presented in conformity with the disclosure and presentation requirements of applicable laws and accounting standards. The working notes given towards the end of this illustration are intended to assist in understanding the manner in which the various figures appearing in the cash flow statement have been derived. These working notes do not form part of the cash flow statement and, accordingly, need not be published.

3. The following additional information is also relevant for the preparation of the statement of cash flows (figures are in Rs.'000).

- (a) An amount of 250 was raised from the issue of share capital and a further 250 was raised from long term borrowings.
- (b) Interest expense was 400 of which 170 was paid during the period. 100 relating to interest expense of the prior period was also paid during the period.
- (c) Dividends paid were 1,200.
- (d) Tax deducted at source on dividends received (included in the tax expense of 300 for the year) amounted to 40.
- (e) During the period, the enterprise acquired fixed assets for 350. The payment was made in cash.
- (f) Plant with original cost of 80 and accumulated depreciation of 60 was sold for 20.
- (g) Foreign exchange loss of 40 represents the reduction in the carrying amount of a short-term investment in foreign-currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investment and the balance sheet date.
- (h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

**Balance Sheet as at 31.12.1996**

(₹ '000)

	1996		1995
<b>Assets</b>			
Cash on hand and balances with banks	200		25
Short-term investments	670		135
Sundry debtors	1,700		1,200
Interest receivable	100		–
Inventories	900		1,950
Long-term investments	2,500		2,500
Fixed assets at cost	2,180		1,910
Accumulated depreciation	<u>(1,450)</u>		<u>(1,060)</u>
Fixed assets (net)	<u>730</u>		<u>850</u>
Total assets	<u>6,800</u>		<u>6,660</u>
<b>Liabilities</b>			
Sundry creditors	150		1,890
Interest payable	230		100
Income taxes payable	400		1,000
Long-term debt	<u>1,110</u>		<u>1,040</u>
Total liabilities	<u>1,890</u>		<u>4,030</u>

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<b>Shareholders' Funds</b>			
Share capital	1,500		1,250
Reserves	3,410		1,380
Total shareholders' funds	4,910		2,630
Total liabilities and shareholders' funds	6,800		6,660

### Statement of Profit and Loss for the period ended 31.12.1996

	(₹ '000)
Sales	30,650
Cost of sales	(26,000)
Gross profit	4,650
Depreciation	(450)
Administrative and selling expenses	(910)
Interest expense	(400)
Interest income	300
Dividend income	200
Foreign exchange loss	(40)
Net profit before taxation and extraordinary item	3,350
Extraordinary item – Insurance proceeds from earthquake disaster settlement	180
Net profit after extraordinary item	3,530
Income-tax	(300)
Net profit	3,230

### Direct Method Cash Flow Statement [Paragraph 18(a)]

	(₹ '000)	
		1996
<b>Cash flows from operating activities</b>		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	(27,600)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	
<i>Net cash from operating activities</i>		1,870
<b>Cash flows from investing activities</b>		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	

Interest received	200	
Dividends received	160	
<i>Net cash from investing activities</i>		30
<b>Cash flows from financing activities</b>		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	<u>(1,200)</u>	
<i>Net cash used in financing activities</i>		(1,150)
<b>Net increase in cash and cash equivalents</b>		750
<b>Cash and cash equivalents at beginning of period (see Note 1)</b>		160
<b>Cash and cash equivalents at end of period (see Note 1)</b>		910

Indirect Method Cash Flow Statement [Paragraph 18(b)]

		(Rs. '000)
		1996
<b>Cash flows from operating activities</b>		
Net profit before taxation, and extraordinary item	3,350	
Adjustments for :		
Depreciation	450	
Foreign exchange loss	40	
Interest income	(300)	
Dividend income	(200)	
Interest expense	<u>400</u>	
Operating profit before working capital changes	3,740	
Increase in sundry debtors	(500)	
Decrease in inventories	1,050	
Decrease in sundry creditors	<u>(1,740)</u>	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	<u>180</u>	
<i>Net cash from operating activities</i>		1,870
<b>Cash flows from investing activities</b>		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	<u>160</u>	

## I.20 Accounting

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<i>Net cash from investing activities</i>		30
<b>Cash flows from financing activities</b>		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	<u>(1,200)</u>	
<i>Net cash used in financing activities</i>		<u>(1,150)</u>
<b>Net increase in cash and cash equivalents</b>		750
<b>Cash and cash equivalents at beginning of period (see Note 1)</b>		<u>160</u>
<b>Cash and cash equivalents at end of period (see Note 1)</b>		<u>910</u>

### Notes to the cash flow statement (direct method and indirect method)

#### 1. Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money-market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts.

	1996	1995
Cash on hand and balances with banks	200	25
Short-term investments	<u>670</u>	<u>135</u>
Cash and cash equivalents	870	160
Effect of exchange rate changes	<u>40</u>	<u>–</u>
Cash and cash equivalents as restated	<u>910</u>	<u>160</u>

Cash and cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely remissible to the company because of currency exchange restrictions.

The company has undrawn borrowing facilities of 2,000 of which 700 may be used only for future expansion.

2. Total tax paid during the year (including tax deducted at source on dividends received) amounted to 900.

#### Alternative Presentation (indirect method)

As an alternative, in an indirect method cash flow statement, operating profit before working capital changes is sometimes presented as follows:

Revenues excluding investment income	30,650
Operating expense excluding depreciation	<u>(26,910)</u>
Operating profit before working capital changes	<u>3,740</u>

#### Working Notes

The working notes given below do not form part of the cash flow statement and, accordingly, need not be published. The purpose of these working notes is merely to assist in understanding the manner in which various figures in the cash flow statement have been derived. (Figures are in ₹'000.)

1. **Cash receipts from customers**

Sales	30,650
<i>Add: Sundry debtors at the beginning of the year</i>	<u>1,200</u>
	31,850
<i>Less : Sundry debtors at the end of the year</i>	<u>1,700</u>
	<u>30,150</u>

 2. **Cash paid to suppliers and employees**

Cost of sales	26,000
Administrative and selling expenses	<u>910</u>
	26,910
<i>Add: Sundry creditors at the beginning of the year</i>	1,890
Inventories at the end of the year	<u>900</u>
	2,790
<i>Less: Sundry creditors at the end of the year</i>	150
Inventories at the beginning of the year	<u>1,950</u>
	2,100
	<u>27,600</u>

 3. **Income taxes paid (including tax deducted at source from dividends received)**

Income tax expense for the year (including tax deducted at source from dividends)	300
<i>Add : Income tax liability at the beginning of the year</i>	<u>1,000</u>
	1,300
<i>Less: Income tax liability at the end of the year</i>	<u>400</u>
	<u>900</u>

Out of 900, tax deducted at source on dividends received (amounting to 40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities (see paragraph 34).

 4. **Repayment of long-term borrowings**

Long-term debt at the beginning of the year	1,040
<i>Add : Long-term borrowings made during the year</i>	<u>250</u>
	1,290
<i>Less : Long-term borrowings at the end of the year</i>	<u>1,110</u>
	<u>180</u>

 5. **Interest paid**

Interest expense for the year	400
<i>Add: Interest payable at the beginning of the year</i>	<u>100</u>
	500
<i>Less: Interest payable at the end of the year</i>	<u>230</u>
	<u>270</u>

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### Illustration II

#### Cash Flow Statement for a Financial Enterprise

This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

1. The illustration shows only current period amounts.
2. The illustration is presented using the direct method.

		(₹ '000)
		1996
<b>Cash flows from operating activities</b>		
Interest and commission receipts	28,447	
Interest payments	(23,463)	
Recoveries on loans previously written off	237	
Cash payments to employees and suppliers	(997)	
Operating profit before changes in operating assets	4,224	
<i>(Increase) decrease in operating assets:</i>		
Short-term funds	(650)	
Deposits held for regulatory or monetary control purposes	234	
Funds advanced to customers	(288)	
Net increase in credit card receivables	(360)	
Other short-term securities	(120)	
<i>Increase (decrease) in operating liabilities:</i>		
Deposits from customers	600	
Certificates of deposit	(200)	
Net cash from operating activities before income tax	3,440	
Income taxes paid	(100)	
<i>Net cash from operating activities</i>		3,340
<b>Cash flows from investing activities</b>		
Dividends received	250	
Interest received	300	
Proceeds from sales of permanent investments	1,200	
Purchase of permanent investments	(600)	
Purchase of fixed assets	(500)	
<i>Net cash from investing activities</i>		650
<b>Cash flows from financing activities</b>		
Issue of shares	1,800	
Repayment of long-term borrowings	(200)	
Net decrease in other borrowings	(1,000)	

Dividends paid	<u>(400)</u>	
<i>Net cash from financing activities</i>		<u>200</u>
<b>Net increase in cash and cash equivalents</b>		<b>4,190</b>
<b>Cash and cash equivalents at beginning of period</b>		<b>4,650</b>
<b>Cash and cash equivalents at end of period</b>		<b>8,840</b>

## AS 6\*: Depreciation Accounting

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in **bold italic** type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities'.]*

### Introduction

1. This Standard deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:—

- (i) forests, plantations and similar regenerative natural resources;
- (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;
- (iii) expenditure on research and development;
- (iv) goodwill and other intangible assets;
- (v) live stock.

This standard also does not apply to land unless it has a limited useful life for the enterprise.

2. Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

### Definitions

3. *The following terms are used in this Standard with the meanings specified:*

**3.1 Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.**

**3.2 Depreciable assets are assets which**

- (i) are expected to be used during more than one accounting period; and
- (ii) have a limited useful life; and

\* Revised in 1994

<sup>1</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

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(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

3.3 Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3.4 Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost<sup>2</sup> in the financial statements, less the estimated residual value.

### Explanation

4. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

- (i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
- (ii) expected useful life of the depreciable asset; and
- (iii) estimated residual value of the depreciable asset.

6. Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

7. The useful life of a depreciable asset is shorter than its physical life and is:

- (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
- (ii) directly governed by extraction or consumption;
- (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
- (iv) reduced by obsolescence arising from such factors as:
  - (a) technological changes;
  - (b) improvement in production methods;
  - (c) change in market demand for the product or service output of the asset; or
  - (d) legal or other restrictions.

8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more

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<sup>2</sup> This Standard does not deal with the treatment of the revaluation difference which may arise when historical costs are substituted by revaluations.

difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

10. Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

11. The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

14. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit

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and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

16. Where the historical cost of an asset has undergone a change due to circumstances specified in para 6 above, the depreciation on the revised unamortised depreciable amount is provided prospectively over the residual useful life of the asset.

### **Disclosure**

17. The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements alongwith the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.

18. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

19. A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.<sup>3</sup>

### **Main Principles**

**20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.**

**21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.**

**22. The useful life of a depreciable asset should be estimated after considering the following factors:**

- (i) expected physical wear and tear;**
- (ii) obsolescence;**
- (iii) legal or other limits on the use of the asset.**

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<sup>3</sup> Refer to AS 5

23. *The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.*

24. *Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.*

25. *Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset.*

26. *Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.*

27. *If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.*

28. *The following information should be disclosed in the financial statements:*

- (i) *the historical cost or other amount substituted for historical cost of each class of depreciable assets;*
- (ii) *total depreciation for the period for each class of assets; and*
- (iii) *the related accumulated depreciation.*

29. *The following information should also be disclosed in the financial statements alongwith the disclosure of other accounting policies:*

- (i) *depreciation methods used; and*
- (ii) *depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.*

## AS 7\*: Construction Contracts

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities'.]*

### Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts,

\* Revised in 2002 and came into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date.

<sup>1</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

## I.28 Accounting

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the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Standard uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.

### Scope

1. *This Standard should be applied in accounting for construction contracts in the financial statements of contractors.*

### Definitions

2. *The following terms are used in this Standard with the meanings specified:*

2.1 *A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.*

2.2 *A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.*

2.3 *A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.*

3. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

4. For the purposes of this Standard, construction contracts include:

- (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
- (b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

5. Construction contracts are formulated in a number of ways which, for the purposes of this Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 22 and 23 in order to determine when to recognise contract revenue and expenses.

### Combining and Segmenting Construction Contracts

6. The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

7. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- (a) separate proposals have been submitted for each asset;
- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- (c) the costs and revenues of each asset can be identified.

8. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

- (a) the group of contracts is negotiated as a single package;
- (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- (c) the contracts are performed concurrently or in a continuous sequence.

9. A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

- (a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
- (b) the price of the asset is negotiated without regard to the original contract price.

### Contract Revenue

10. Contract revenue should comprise:

- (a) the initial amount of revenue agreed in the contract; and
- (b) variations in contract work, claims and incentive payments:
  - (i) to the extent that it is probable that they will result in revenue; and
  - (ii) they are capable of being reliably measured.

11. Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

- (a) a contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;
- (b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;
- (c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or
- (d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

12. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:

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- (a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and
- (b) the amount of revenue can be reliably measured.

13. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are only included in contract revenue when:

- (a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and
- (b) the amount that it is probable will be accepted by the customer can be measured reliably.

14. Incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when:

- (a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
- (b) the amount of the incentive payment can be measured reliably.

### Contract Costs

15. **Contract costs should comprise:**

- (a) **costs that relate directly to the specific contract;**
- (b) **costs that are attributable to contract activity in general and can be allocated to the contract; and**
- (c) **such other costs as are specifically chargeable to the customer under the terms of the contract.**

16. Costs that relate directly to a specific contract include:

- (a) site labour costs, including site supervision;
- (b) costs of materials used in construction;
- (c) depreciation of plant and equipment used on the contract;
- (d) costs of moving plant, equipment and materials to and from the contract site;
- (e) costs of hiring plant and equipment;
- (f) costs of design and technical assistance that is directly related to the contract;
- (g) the estimated costs of rectification and guarantee work, including expected warranty costs; and
- (h) claims from third parties.

These costs may be reduced by any incidental income that is not included in contract revenue, for example income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

17. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

- (a) insurance;
- (b) costs of design and technical assistance that is not directly related to a specific contract; and
- (c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs as per Accounting Standard (AS) 16, Borrowing Costs.

18. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

19. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

- (a) general administration costs for which reimbursement is not specified in the contract;
- (b) selling costs;
- (c) research and development costs for which reimbursement is not specified in the contract; and
- (d) depreciation of idle plant and equipment that is not used on a particular contract.

20. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

### Recognition of Contract Revenue and Expenses

21. *When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.*

22. *In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:*

- (a) *total contract revenue can be measured reliably;*
- (b) *it is probable that the economic benefits associated with the contract will flow to the enterprise;*
- (c) *both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and*
- (d) *the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.*

23. *In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:*

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- (a) *it is probable that the economic benefits associated with the contract will flow to the enterprise; and*
- (b) *the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.*

24. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

25. Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

26. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

27. When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

28. An enterprise is generally able to make reliable estimates after it has agreed to a contract which establishes:

- (a) each party's enforceable rights regarding the asset to be constructed;
- (b) the consideration to be exchanged; and
- (c) the manner and terms of settlement.

It is also usually necessary for the enterprise to have an effective internal financial budgeting and reporting system. The enterprise reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

29. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
- (b) surveys of work performed; or
- (c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

30. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:

- (a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and
- (b) payments made to subcontractors in advance of work performed under the subcontract.

31. **When the outcome of a construction contract cannot be estimated reliably:**

- (a) **revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and**
- (b) **contract costs should be recognised as an expense in the period in which they are incurred.**

**An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.**

32. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

33. Contract costs recovery of which is not probable are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may, therefore, need to be recognised as an expense immediately include contracts:

- (a) which are not fully enforceable, that is, their validity is seriously in question;
- (b) the completion of which is subject to the outcome of pending litigation or legislation;
- (c) relating to properties that are likely to be condemned or expropriated;
- (d) where the customer is unable to meet its obligations; or
- (e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

34. **When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognised in accordance with paragraph 21 rather than in accordance with paragraph 31.**

### Recognition of Expected Losses

35. **When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.**

36. The amount of such a loss is determined irrespective of:

- (a) whether or not work has commenced on the contract;

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- (b) the stage of completion of contract activity; or
- (c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 8.

### Changes in Estimates

37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies). The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

### Disclosure

**38. An enterprise should disclose:**

- (a) *the amount of contract revenue recognised as revenue in the period;*
- (b) *the methods used to determine the contract revenue recognised in the period; and*
- (c) *the methods used to determine the stage of completion of contracts in progress.*

**39. An enterprise should disclose the following for contracts in progress at the reporting date:**

- (a) *the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;*
- (b) *the amount of advances received; and*
- (c) *the amount of retentions.*

40. Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.

**41. An enterprise should present:**

- (a) *the gross amount due from customers for contract work as an asset; and*
- (b) *the gross amount due to customers for contract work as a liability.*

42. The gross amount due from customers for contract work is the net amount of:

- (a) costs incurred plus recognised profits; less
- (b) the sum of recognised losses and progress billings

for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

43. The gross amount due to customers for contract work is the net amount of:

- (a) the sum of recognised losses and progress billings; less
- (b) costs incurred plus recognised profits

for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).

44. An enterprise discloses any contingencies in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date<sup>2</sup>. Contingencies may arise from such items as warranty costs, penalties or possible losses.

### Illustration

*This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.*

### Disclosure of Accounting Policies

The following are illustrations of accounting policy disclosures:

Revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred upto the reporting date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred upto the reporting date bear to the estimated total costs of the contract.

### The Determination of Contract Revenue and Expenses

The following illustration illustrates one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 21 to 34 of the Standard). (Amounts shown hereinbelow are in Rs. lakhs)

A construction contractor has a fixed price contract for Rs. 9,000 to build a bridge. The initial amount of revenue agreed in the contract is Rs. 9,000. The contractor's initial estimate of contract costs is Rs. 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor's estimate of contract costs has increased to Rs. 8,050.

In year 2, the customer approves a variation resulting in an increase in contract revenue of Rs. 200 and estimated additional contract costs of Rs. 150. At the end of year 2, costs incurred include Rs. 100 for standard materials stored at the site to be used in year 3 to complete the project.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed upto the reporting date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

	(amount in Rs. lakhs)		
	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	—	200	200
Total contract revenue	<u>9,000</u>	<u>9,200</u>	<u>9,200</u>
Contract costs incurred upto the reporting date	2,093	6,168	8,200
Contract costs to complete	<u>5,957</u>	<u>2,032</u>	—

<sup>2</sup> Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

## I.36 Accounting

Total estimated contract costs	<u>8,050</u>	<u>8,200</u>	<u>8,200</u>
Estimated Profit	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed upto the reporting date, Rs. 100 of standard materials stored at the site for use in year 3.

The amounts of revenue, expenses and profit recognised in the statement of profit and loss in the three years are as follows:

	Recognised in Prior years	Recognised in current year
<b>Year 1</b>		
Revenue (9,000x .26)	2,340	2,340
Expenses (8,050x .26)	<u>2,093</u>	<u>2,093</u>
Profit	<u>247</u>	<u>247</u>

<b>Year 2</b>			
Revenue (9,200x .74)	6,808	2,340	4,468
Expenses (8,200x .74)	<u>6,068</u>	<u>2,093</u>	<u>3,975</u>
Profit	<u>740</u>	<u>247</u>	<u>493</u>
<b>Year 3</b>			
Revenue (9,200x 1.00)	9,200	6,808	2,392
Expenses	<u>8,200</u>	<u>6,068</u>	<u>2,132</u>
Profit	<u>1,000</u>	<u>740</u>	<u>260</u>

### Contract Disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance upto the reporting date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

	Contract (amount in Rs. lakhs)					
	A	B	C	D	E	Total
Contract Revenue recognised in accordance with paragraph 21	145	520	380	200	55	1,300
Contract Expenses recognised in accordance with paragraph 21	110	450	350	250	55	1,215

Expected Losses recognised in accordance with paragraph 35	=	=	=	40	30	70
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract Costs incurred in the period	110	510	450	250	100	1,420
Contract Costs incurred recognised as contract expenses in the period in accordance with paragraph 21	110	450	350	250	55	1,215
Contract Costs that relate to future activity recognised as an asset in accordance with paragraph 26	—	60	100	—	45	205
Contract Revenue (see above)	145	520	380	200	55	1,300
Progress Billings (paragraph 40)	100	520	380	180	55	1,235
Unbilled Contract Revenue	45	—	—	20	—	65
Advances (paragraph 40)	—	80	20	—	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period [paragraph 38(a)] 1,300

Contract costs incurred and recognised profits

(less recognised losses) upto the reporting date [paragraph 39(a)] 1,435

Advances received [paragraph 39(b)] 125

Gross amount due from customers for contract work —

presented as an asset in accordance with paragraph 41(a) 220

Gross amount due to customers for contract work —

presented as a liability in accordance with paragraph 41(b) (20)

The amounts to be disclosed in accordance with paragraphs 39(a), 41(a) and 41(b) are calculated as follows:

A	B	C	D	E	(amount in Rs. lakhs)	
					Total	
Contract Costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435
Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	—	15	220
Due to customers	—	—	—	(20)	—	(20)

The amount disclosed in accordance with paragraph 39(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

## AS 9\* : Revenue Recognition<sup>1</sup>

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in **bold italic** type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards<sup>2</sup> and the 'Applicability of Accounting Standards to Various Entities'.]*

### Introduction

1. This Standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from
  - the sale of goods,
  - the rendering of services, and
  - the use by others of enterprise resources yielding interest, royalties and dividends.
2. This Standard does not deal with the following aspects of revenue recognition to which special considerations apply:
  - (i) Revenue arising from construction contracts<sup>3</sup>
  - (ii) Revenue arising from hire-purchase, lease agreements;
  - (iii) Revenue arising from government grants and other similar subsidies;
  - (iv) Revenue of insurance companies arising from insurance contracts.
3. Examples of items not included within the definition of "revenue" for the purpose of this Standard are:
  - (i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
  - (ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
  - (iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
  - (iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;
  - (v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

### Definitions

4. **The following terms are used in this Standard with the meanings specified:**

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\* Issued in 1985

<sup>1</sup> It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.

<sup>2</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

<sup>3</sup> Refer to AS 7 on 'Construction Contracts'.

**4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise<sup>4</sup> from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.**

**4.2 Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.**

**4.3 Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.**

### **Explanation**

5. Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

### **6. Sale of Goods**

6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

6.2 At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Standard, are sometimes recognised in the statement of profit and loss and appropriately described.

### **7. Rendering of Services**

7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

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<sup>4</sup> The Institute has issued an Announcement in 2005 titled 'Treatment of Inter-divisional Transfers'. As per the Announcement, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard 9.

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- (i) **Proportionate completion method**—Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.
- (ii) **Completed service contract method**—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

## 8. The Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

8.1 The use by others of such enterprise resources gives rise to:

- (i) interest—charges for the use of cash resources or amounts due to the enterprise;
- (ii) royalties—charges for the use of such assets as know-how, patents, trade marks and copyrights;
- (iii) dividends—rewards from the holding of investments in shares.

8.2 Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity.

8.3 Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

8.4 Dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

8.5 When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

## 9. Effect of Uncertainties on Revenue Recognition

9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.5 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

## Main Principles

**10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.**

### Explanation :

*The amount of revenue from sales transactions (turnover) should be disclosed in the following manner on the face of the statement of profit or loss :*

<i>Turnover (Gross)</i>	<i>XX</i>	
<i>Less: Excise Duty</i>	<i><u>XX</u></i>	
<i>Turnover (Net)</i>		<i>XX</i>

*The amount of excise duty to be deducted from the turnover should be the total excise duty for the year except the excise duty related to the difference between the closing start and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit or loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.*

**11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:**

- (i) *the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and*
- (ii) *no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.*

**12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.**

**13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:**

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- (i) *Interest* : *on a time proportion basis taking into account the amount outstanding and the rate applicable.*
- (ii) *Royalties* : *on an accrual basis in accordance with the terms of the relevant agreement.*
- (iii) *Dividends from investments in shares* : *when the owner's right to receive payment is established.*

### **Disclosure**

**14. In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.**

### **Illustrations**

These illustrations do not form part of the Accounting Standard. Their purpose is to illustrate the application of the Standard to a number of commercial situations in an endeavour to assist in clarifying application of the Standard.

#### **A. Sale of Goods**

1. *Delivery is delayed at buyer's request and buyer takes title and accepts billing*

Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

2. *Delivered subject to conditions*

- (a) installation and inspection i.e. goods are sold subject to installation, inspection etc.

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory-tested television receiver normally only requires unpacking and connecting of power and antennae).

- (b) on approval

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

- (c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

- (d) consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor

Revenue should not be recognised until the goods are sold to a third party.

(e) cash on delivery sales

Revenue should not be recognised until cash is received by the seller or his agent.

3. *Sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received*

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

4. *Special order and shipments i.e. where payment (or partial payment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party*

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

5. *Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date*

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

6. *Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale*

Revenue from such sales can generally be recognised if significant risks of ownership have passed; however in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

7. *Subscriptions for publications*

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

8. *Instalment sales*

When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

9. *Trade discounts and volume rebates*

Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

**B. Rendering of Services**

1. *Installation Fees*

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

2. *Advertising and insurance agency commissions*

Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production

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commission, which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

### 3. Financial service commissions

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:

- (a) whether the service has been provided "once and for all" or is on a "continuing" basis;
- (b) the incidence of the costs relating to the service;
- (c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

### 4. Admission fees

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

### 5. Tuition fees

Revenue should be recognised over the period of instruction.

### 6. Entrance and membership fees

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

## AS 10: Accounting for Fixed Assets\*

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in **bold italic** type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities'.]*

### Introduction

1. Financial Statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land, buildings, plant and machinery,

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\* issued in 1985

<sup>1</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

vehicles, furniture and fittings, goodwill, patents, trade marks and designs. This standard deals with accounting for such fixed assets except as described in paragraphs 2 to 5 below.

2. This standard does not deal with the specialised aspects of accounting for fixed assets that arise under a comprehensive system reflecting the effects of changing prices but applies to financial statements prepared on historical cost basis.

3. This standard does not deal with accounting for the following items to which special considerations apply:

- (i) forests, plantations and similar regenerative natural resources;
- (ii) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources;
- (iii) expenditure on real estate development; and
- (iv) livestock.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (i) to (iv) above, but separable from those activities, are to be accounted for in accordance with this Standard.

4. This standard does not cover the allocation of the depreciable amount of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on 'Depreciation Accounting'.

5. This standard does not deal with the treatment of government grants and subsidies, and assets under leasing rights. It makes only a brief reference to the capitalisation of borrowing costs and to assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within this Standard.

## Definitions

6. *The following terms are used in this Standard with the meanings specified:*

6.1 *Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.*

6.2 *Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.*

6.3 *Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.*

## Explanation

7. Fixed assets often comprise a significant portion of the total assets of an enterprise, and therefore are important in the presentation of financial position. Furthermore, the determination of whether an expenditure represents an asset or an expense can have a material effect on an enterprise's reported results of operations.

## 8. Identification of Fixed Assets

8.1 The definition in paragraph 6.1 gives criteria for determining whether items are to be classified as fixed assets. Judgement is required in applying the criteria to specific circumstances or specific types of enterprises. It may be appropriate to aggregate individually insignificant items, and to apply the

## **I.46 Accounting**

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criteria to the aggregate value. An enterprise may decide to expense an item which could otherwise have been included as fixed asset, because the amount of the expenditure is not material.

8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

8.3 In certain circumstances, the accounting for an item of fixed asset may be improved if the total expenditure thereon is allocated to its component parts, provided they are in practice separable, and estimates are made of the useful lives of these components. For example, rather than treat an aircraft and its engines as one unit, it may be better to treat the engines as a separate unit if it is likely that their useful life is shorter than that of the aircraft as a whole.

### **9. Components of Cost**

9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

- (i) site preparation;
- (ii) initial delivery and handling costs;
- (iii) installation cost, such as special foundations for plant; and
- (iv) professional fees, for example fees of architects and engineers. The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.

9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.

9.4 If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. However, the expenditure incurred during this period is also sometimes treated as deferred revenue expenditure to be amortised over a period not exceeding 3 to 5 years after the commencement of commercial production.<sup>2</sup>

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<sup>2</sup> It may be noted that this paragraph relates to "all expenses" incurred during the period. This expenditure would also include borrowing costs incurred during the said period. Since Accounting Standard (AS) 16, Borrowing Costs, specifically deals with the treatment of borrowing costs, the treatment provided by AS 16 would prevail over the provisions in this respect contained in this paragraph as these provisions are general in nature and apply to "all expenses".

## 10. Self-constructed Fixed Assets

10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

## 11. Non-monetary Consideration

11.1 When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration.

11.2 When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

## 12. Improvements and Repairs

12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately.

## 13. Amount Substituted for Historical Cost

13.1 Sometimes financial statements that are otherwise prepared on a historical cost basis include part or all of fixed assets at a valuation in substitution for historical costs and depreciation is calculated accordingly. Such financial statements are to be distinguished from financial statements prepared on a basis intended to reflect comprehensively the effects of changing prices.

13.2 A commonly accepted and preferred method of restating fixed assets is by appraisal, normally undertaken by competent valuers. Other methods sometimes used are indexation and reference to current prices which when applied are cross checked periodically by appraisal method.

13.3 The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the profit and loss statement the accumulated depreciation existing at the date of revaluation.

13.4 Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis.

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13.5 Selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements. Accordingly, when revaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit.

13.6 It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class.

13.7 An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease.

### **14. Retirements and Disposals**

14.1 An item of fixed asset is eliminated from the financial statements on disposal.

14.2 Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement.

14.3 In historical cost financial statements, gains or losses arising on disposal are generally recognised in the profit and loss statement.

14.4 On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

### **15. Valuation of Fixed Assets in Special Cases**

15.1 In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.<sup>3</sup>

15.2 Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the *pro rata* cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

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<sup>3</sup> Accounting Standard (AS) 19, Leases, came into effect in respect of assets leased during accounting periods commencing on or after 1-4-2001. AS 19 also applies to assets acquired on hire purchase during accounting periods commencing on or after 1-4-2001. Accordingly, this paragraph is not applicable in respect of assets acquired on hire purchase during accounting periods commencing on or after 1-4-2001.

15.3 Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

### 16. Fixed Assets of Special Types

16.1 Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable either in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess is termed as 'goodwill'. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.

16.2 As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

### 17. Disclosure

17.1 Certain specific disclosures on accounting for fixed assets are already required by Accounting Standard 1 on 'Disclosure of Accounting Policies' and Accounting Standard 6 on 'Depreciation Accounting'.

17.2 Further disclosures that are sometimes made in financial statements include:

- (i) gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;
- (ii) expenditure incurred on account of fixed assets in the course of construction or acquisition; and
- (iii) revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

## Main Principles

18. *The items determined in accordance with the definition in paragraph 6.1 of this Standard should be included under fixed assets in financial statements.*

19. *The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with this Standard. The method of accounting for fixed assets included at historical cost is set out in paragraphs 20 to 26; the method of accounting of revalued assets is set out in paragraphs 27 to 32.*

20. *The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.*

21. *The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.*

22. *When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident. Fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its*

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*fair market value, or the fair market value of the securities issued, whichever is more clearly evident.*

**23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.**

**24. Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.**

**25. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.**

**26. Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognised in the profit and loss statement.**

**27. When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed.**

**28. The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable amount of assets of that class.**

**29. When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statement.**

**30. An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.**

**31. The provisions of paragraphs 23, 24 and 25 are also applicable to fixed assets included in financial statements at a revaluation.**

**32. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value should be charged or credited to the profit and loss statement except that to the extent that such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.**

**33. Fixed assets acquired on hire purchase terms should be recorded at their cash value, which, if not readily available, should be calculated by assuming an appropriate rate of interest. They should be shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.<sup>4</sup>**

**34. In the case of fixed assets owned by the enterprise jointly with others, the extent of the enterprise's share in such assets, and the proportion of the original cost, accumulated depreciation and written down value should be stated in the balance sheet. Alternatively, the pro**

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<sup>4</sup> see footnote 3.

*rata cost of such jointly owned assets may be grouped together with similar fully owned assets with an appropriate disclosure thereof.*

**35. Where several fixed assets are purchased for a consolidated price, the consideration should be apportioned to the various assets on a fair basis as determined by competent valuers.**

**36. Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be termed as 'goodwill'.**

### **Disclosure**

**37. The following information should be disclosed in the financial statements:**

- (i) **gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;**
- (ii) **expenditure incurred on account of fixed assets in the course of construction or acquisition; and**
- (iii) **revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.**

## **AS 13\*: Accounting for Investments**

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in **bold italic** type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities'.]*

### **Introduction**

1. This Standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.<sup>2</sup>
2. This Standard does not deal with:
  - (a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 on Revenue Recognition;
  - (b) operating or finance leases;

\* This standard was issued in 1993. A limited revision to this Standard was made in 2003, pursuant to which paragraph 2 (d) of this Standard has been revised to include 'and venture capital funds'.

<sup>1</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

<sup>2</sup> Shares, debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are not 'investments' as defined in this Standard. However, the manner in which they are accounted for and disclosed in the financial statements is quite similar to that applicable in respect of current investments. Accordingly, the provisions of this Standard, to the extent that they relate to current investments, are also applicable to shares, debentures and other securities held as stock-in-trade, with suitable modifications as specified in this Standard.

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- (c) investments of retirement benefit plans and life insurance enterprises; and
- (d) mutual funds and venture capital funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

### Definitions

3. *The following terms are used in this Standard with the meanings assigned:*

3.1 *Investments* are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'.

3.2 *A current investment* is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

3.3 *A long term investment* is an investment other than a current investment.

3.4 *An investment property* is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

3.5 *Fair value* is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

3.6 *Market value* is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

### Explanation

#### Forms of Investments

4. Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

5. Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). The nature of an investment may be that of a debt, other than a short or long term loan or a trade debt, representing a monetary amount owing to the holder and usually bearing interest; alternatively, it may be a stake in the results and net assets of an enterprise such as an equity share. Most investments represent financial rights, but some are tangible, such as certain investments in land or buildings.

6. For some investments, an active market exists from which a market value can be established. For such investments, market value generally provides the best evidence of fair value. For other investments, an active market does not exist and other means are used to determine fair value.

#### Classification of Investments

7. Enterprises present financial statements that classify fixed assets, investments and current assets into separate categories. Investments are classified as long term investments and current

investments. Current investments are in the nature of current assets, although the common practice may be to include them in investments.<sup>3</sup>

8. Investments other than current investments are classified as long term investments, even though they may be readily marketable.

### **Cost of Investments**

9. The cost of an investment includes acquisition charges such as brokerage, fees and duties.

10. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which, in appropriate cases, may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

11. If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

12. Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

13. When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

### **Carrying Amount of Investments**

#### **Current Investments**

14. The carrying amount for current investments is the lower of cost and fair value. In respect of investments for which an active market exists, market value generally provides the best evidence of fair value. The valuation of current investments at lower of cost and fair value provides a prudent method of determining the carrying amount to be stated in the balance sheet.

15. Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly the investments may be carried at the lower of cost and fair value computed categorywise (i.e. equity shares, preference shares, convertible debentures, etc.). However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.

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<sup>3</sup> Shares, debentures and other securities held for sale in the ordinary course of business are disclosed as 'stock-in-trade' under the head 'current assets'.

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16. For current investments, any reduction to fair value and any reversals of such reductions are included in the profit and loss statement.

### ***Long-term Investments***

17. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment.

18. Long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis.

19. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

### **Investment Properties**

20. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

### **Disposal of Investments**

21. On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

22. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.<sup>4</sup>

### **Reclassification of Investments**

23. Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

24. Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

### **Disclosure**

25. The following disclosures in financial statements in relation to investments are appropriate:—

- (a) the accounting policies for the determination of carrying amount of investments;
- (b) the amounts included in profit and loss statement for:
  - (i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current

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<sup>4</sup> In respect of shares, debentures and other securities held as stock-in-trade, the cost of stocks disposed of is determined by applying an appropriate cost formula (e.g. first-in, first-out; average cost, etc.). These cost formulae are the same as those specified in Accounting Standard (AS) 2, in respect of Valuation of Inventories.

investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;

- (ii) profits and losses on disposal of current investments and changes in carrying amount of such investments;
- (iii) profits and losses on disposal of long term investments and changes in the carrying amount of such investments;
- (c) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;
- (d) the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;
- (e) other disclosures as specifically required by the relevant statute governing the enterprise.

## Main Principles

### Classification of Investments

26. *An enterprise should disclose current investments and long term investments distinctly in its financial statements.*

27. *Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:*

- (a) *Government or Trust securities*
- (b) *Shares, debentures or bonds*
- (c) *Investment properties*
- (d) *Others—specifying nature.*

### Cost of Investments

28. *The cost of an investment should include acquisition charges such as brokerage, fees and duties.*

29. *If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.*

### Investment Properties

30. *An enterprise holding investment properties should account for them as long term investments.*

### Carrying Amount of Investments

31. *Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.*

32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

#### **Changes in Carrying Amounts of Investments**

33. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

#### **Disposal of Investments**

34. On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.

#### **Disclosure**

35. The following information should be disclosed in the financial statements:

- (a) the accounting policies for determination of carrying amount of investments;
- (b) classification of investments as specified in paragraphs 26 and 27 above;
- (c) the amounts included in profit and loss statement for:
  - (i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;
  - (ii) profits and losses on disposal of current investments and changes in the carrying amount of such investments; and
  - (iii) profits and losses on disposal of long term investments and changes in the carrying amount of such investments;
- (d) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;
- (e) the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;
- (f) other disclosures as specifically required by the relevant statute governing the enterprise.

#### **Effective Date**

36. This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

## AS 14\*: Accounting for Amalgamations

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in **bold italic** type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards<sup>1</sup> and the 'Applicability of Accounting Standards to Various Entities').]*

### Introduction

1. This standard deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This Standard is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.
2. This standard does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

### Definitions

3. *The following terms are used in this standard with the meanings specified:*
  - (a) *Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.*
  - (b) *Transferor company means the company which is amalgamated into another company.*
  - (c) *Transferee company means the company into which a transferor company is amalgamated.*
  - (d) *Reserve means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.*
  - (e) *Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.*
    - (i) *All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.*
    - (ii) *Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.*

\* Issued in 1994. A limited revision to this Standard was made in 2004, pursuant to which paragraphs 23 and 42 of this Standard were revised.

<sup>1</sup> Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

- (iii) *The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.*
- (iv) *The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.*
- (v) *No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.*
- (f) *Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified in sub-paragraph (e) above.*
- (g) *Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.*
- (h) *Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.*
- (i) *Pooling of interests is a method of accounting for amalgamations the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.*

### Explanation

#### Types of Amalgamations

4. Generally speaking, amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. Such amalgamations are amalgamations which are in the nature of 'merger' and the accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies. In the second category are those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

5. An amalgamation is classified as an 'amalgamation in the nature of merger' when all the conditions listed in paragraph 3(e) are satisfied. There are, however, differing views regarding the nature of any further conditions that may apply. Some believe that, in addition to an exchange of equity shares, it is necessary that the shareholders of the transferor company obtain a substantial share in the transferee company even to the extent that it should not be possible to identify any one party as dominant therein. This belief is based in part on the view that the exchange of control of one company

for an insignificant share in a larger company does not amount to a mutual sharing of risks and benefits.

6. Others believe that the substance of an amalgamation in the nature of merger is evidenced by meeting certain criteria regarding the relationship of the parties, such as the former independence of the amalgamating companies, the manner of their amalgamation, the absence of planned transactions that would undermine the effect of the amalgamation, and the continuing participation by the management of the transferor company in the management of the transferee company after the amalgamation.

### **Methods of Accounting for Amalgamations**

7. There are two main methods of accounting for amalgamations:

- (a) the pooling of interests method; and
- (b) the purchase method.

8. The use of the pooling of interests method is confined to circumstances which meet the criteria referred to in paragraph 3(e) for an amalgamation in the nature of merger.

9. The object of the purchase method is to account for the amalgamation by applying the same principles as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase.

#### *The Pooling of Interests Method*

10. Under the pooling of interests method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the adjustments required in paragraph 11).

11. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

#### *The Purchase Method*

12. Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

13. Where assets and liabilities are restated on the basis of their fair values, the determination of fair values may be influenced by the intentions of the transferee company. For example, the transferee company may have a specialised use for an asset, which is not available to other potential buyers. The transferee company may intend to effect changes in the activities of the transferor company which necessitate the creation of specific provisions for the expected costs, e.g. planned employee termination and plant relocation costs.

### **Consideration**

14. The consideration for the amalgamation may consist of securities, cash or other assets. In determining the value of the consideration, an assessment is made of the fair value of its elements. A variety of techniques is applied in arriving at fair value. For example, when the consideration includes

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securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

15. Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date].

### Treatment of Reserves on Amalgamation

16. If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

17. If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves dealt with in paragraph 18, is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and dealt with in the manner stated in paragraphs 19-20. If the result of the computation is positive, the difference is credited to Capital Reserve.

18. Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under, the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

### **Treatment of Goodwill Arising on Amalgamation**

19. Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

20. Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include:

- (a) the foreseeable life of the business or industry;
- (b) the effects of product obsolescence, changes in demand and other economic factors;
- (c) the service life expectancies of key individuals or groups of employees;
- (d) expected actions by competitors or potential competitors; and
- (e) legal, regulatory or contractual provisions affecting the useful life.

### **Balance of Profit and Loss Account**

21. In the case of an 'amalgamation in the nature of merger', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

22. In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

### **Treatment of Reserves Specified in a Scheme of Amalgamation**

23. The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute may prescribe the treatment to be given to the reserves of the transferor company after its amalgamation. Where the treatment is so prescribed, the same is followed. In some cases, the scheme of amalgamation sanctioned under a statute may prescribe a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme. In such cases, the following disclosures are made in the first financial statements following the amalgamation:

- (a) A description of the accounting treatment given to the reserves and the reasons for following the treatment different from that prescribed in this Standard.
- (b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.
- (c) The financial effect, if any, arising due to such deviation.

### **Disclosure**

24. For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

- (a) names and general nature of business of the amalgamating companies;
- (b) effective date of amalgamation for accounting purposes;

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- (c) the method of accounting used to reflect the amalgamation; and
- (d) particulars of the scheme sanctioned under a statute.

25. For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

- (a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;
- (b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

26. For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

- (a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and
- (b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

### Amalgamation after the Balance Sheet Date

27. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

### Main Principles

28. **An amalgamation may be either –**

- (a) ***an amalgamation in the nature of merger, or***
- (b) ***an amalgamation in the nature of purchase.***

29. **An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied:**

- (i) ***All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.***
- (ii) ***Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.***
- (iii) ***The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.***

- (iv) *The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.*
- (v) *No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.*

30. *An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified in paragraph 29 is not satisfied.*

31. *When an amalgamation is considered to be an amalgamation in the nature of merger, it should be accounted for under the pooling of interests method described in paragraphs 33–35.*

32. *When an amalgamation is considered to be an amalgamation in the nature of purchase, it should be accounted for under the purchase method described in paragraphs 36–39.*

#### ***The Pooling of Interests Method***

33. *In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.*

34. *If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS) 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.*

35. *The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves.*

#### ***The Purchase Method***

36. *In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as stated in paragraph 39.*

37. *Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.*

38. *The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.*

39. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

#### Common Procedures

40. The consideration for the amalgamation should include any non- cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

41. Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date].

#### Treatment of Reserves Specified in a Scheme of Amalgamation

42. Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. Where the scheme of amalgamation sanctioned under a statute prescribes a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme, the following disclosures should be made in the first financial statements following the amalgamation:

- (a) A description of the accounting treatment given to the reserves and reasons for following the treatment different from that prescribed in this Standard.
- (b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.
- (c) The financial effect, if any, arising due to such deviation.

#### Disclosure

43. For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

- (a) names and general nature of business of the amalgamating companies;
- (b) effective date of amalgamation for accounting purposes;
- (c) the method of accounting used to reflect the amalgamation; and
- (d) particulars of the scheme sanctioned under a statute.

44. For amalgamations accounted for under the pooling of interests method, the following additional disclosures should be made in the first financial statements following the amalgamation:

- (a) *description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;*
- (b) *the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.*

45. For amalgamations accounted for under the purchase method, the following additional disclosures should be made in the first financial statements following the amalgamation:

- (a) *consideration for the amalgamation and a description of the consideration paid or contingently payable; and*
- (b) *the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.*

#### **Amalgamation after the Balance Sheet Date**

46. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation should not be incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.